7 T.C. 363 (1946)

The income from a trust is not taxable to the settlor when the settlor's retained powers do not provide direct economic benefit or control tantamount to ownership, and the trust income is not used to discharge the settlor's legal obligations.

Summary

David L. Loew created three irrevocable trusts for his children, naming his brother as trustee. Loew retained certain powers, including directing income accumulation during minority, removing the trustee, and controlling investments. The IRS argued the trust income was taxable to Loew under Sections 22(a) and 167 of the Internal Revenue Code. The Tax Court held the trust income was not taxable to Loew because the retained powers did not provide him with direct economic benefit or control, and the trust income was not used for his children's support, which was his legal obligation. The court also addressed the deductibility of accounting expenses and the characterization of income earned before and after establishing California residency.

Facts

- David L. Loew created three irrevocable trusts in 1935 for the benefit of his three minor children.
- Loew's brother served as trustee.
- The trusts were to terminate when the sons reached 30 and the daughter reached 35, with the corpus then distributed to the beneficiaries.
- Loew retained the power to: (1) direct the accumulation of trust income during the beneficiaries' minority; (2) remove the trustee and appoint a successor; (3) control trust investments; and (4) receive the net income as parent of the beneficiaries.
- Income received for the children was deposited in separate bank accounts and not used for their support.

Procedural History

- The Commissioner of Internal Revenue determined deficiencies in Loew's income tax for 1938, 1939, and 1940.
- The Commissioner argued that the trust income was taxable to Loew.
- The Tax Court ruled in favor of Loew regarding the trust income.

Issue(s)

1. Whether the income of the three trusts is taxable to the settlor, Loew, given the powers he retained.
2. Whether certain accounting expenses are deductible.
3. Whether $1,500 received in 1939 for services rendered in prior years is taxable income in 1939 and, if so, whether any portion is community income.

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Holding

1. No, the trust income is not taxable to Loew because the retained powers did not amount to substantial ownership or control, nor did they allow him to benefit economically from the trust.
2. Yes, the accounting expenses are deductible because they were directly connected with managing property held for the production of income.
3. Yes, the $1,500 is taxable income in 1939, with a portion taxable as separate income and the remainder as community income, based on the period when the services were performed and Loew's residency status.

Court's Reasoning

- The court distinguished the case from *Helvering v. Clifford*, noting that Loew's trusts were of longer duration and that his retained powers did not give him the same degree of control or the possibility of economic benefit.
- The court reasoned that the power to direct income accumulation was limited to the beneficiaries' minority and would ultimately benefit them. The power to remove the trustee did not automatically inure to Loew's benefit.
- The court emphasized that as a man of considerable means, Loew was legally obligated to support his children under California law. Therefore, the power to receive income on their behalf did not imply that he could use it for his own benefit.
- Regarding accounting expenses, the court relied on *Bingham Trust v. Commissioner*, which held that expenses directly connected with managing property held for income production are deductible. Preparing tax returns and managing investments fall under this category.
- The court determined that the $1,500 was taxable in the year received, consistent with Loew's cash basis accounting. The portion earned before Loew became a California resident was separate income; the rest was community income.

Practical Implications

- This case clarifies the boundaries of settlor control over trusts without triggering taxation of the trust income to the settlor. It emphasizes that retained powers must provide a direct, tangible economic benefit to the settlor to justify taxation.
- It highlights the importance of state law in determining parental obligations. If a parent is financially capable of supporting their children, trust income for those children is less likely to be attributed to the parent.
- The ruling on accounting expenses has been superseded by later changes in tax law and regulations, but it reflects a broader principle that expenses related to income production are generally deductible.
- This case informs the drafting of trust agreements to avoid unintended tax consequences for the settlor and provides a framework for analyzing the

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taxability of trust income when settlors retain certain powers.

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